Rebuilding Confidence in Asia--Remarks by Michel Camdessus

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Remarks by Michel Camdessus
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Thank you, ladies and gentlemen. I am very pleased to have this opportunity to speak to you, the business leaders of southeast Asia, at this critical moment in the region's economy. The crisis that began in Thailand has now shaken a number of other economies in the region, and its aftershocks have been felt as far away as Latin America and eastern Europe. Countries that have been accustomed to, in some cases, decades of high growth now face the prospect of a marked slowdown in economic activity. This has prompted some observers to suggest that perhaps the so-called "Asian miracle" was only a "mirage."

I do not hold that view. In my opinion, the region's economic success over the last couple of decades can be described in many ways--as outstanding, superlative, and certainly admirable. But it was no "miracle." Rather, it was the result of good policies that fostered saving and investment, including in human development; encouraged innovation and entrepreneurship and a quick response to market signals; and promoted trade. Recent developments have not wiped out past achievements. On the contrary, the region's longer term fundamentals--including its high domestic savings rates, strong fiscal positions, dynamic private sectors, and competitiveness--remain favorable. Moreover, most Asian countries still have a long way to go to catch up with advanced economies. Thus, to all the prophets of gloom and doom I would reply that with a lucid diagnosis of the problems, without complacency, and with appropriate economic adjustments now and sound policies in the future, these countries will be able to rekindle--in a more sustainable way--high rates of growth in the coming years.

In a situation, like the current one, that is evolving quickly, it is difficult to step back and take a longer view. But indeed that is what is required to get to the root of the region's problems and find appropriate solutions. In this spirit, I would like to talk very candidly with you about the causes of the current crisis and what they suggest about the requirements for rebuilding confidence in this dynamic region.

Causes of the crisis

Let me start with the question that so many have asked: how could events in southeast Asia unfold this way, after so many years of outstanding economic performance?

In the case of Thailand, the answer is fairly clear. To begin with, standard economic indicators revealed large macroeconomic imbalances: the real exchange rate had appreciated considerably; export growth had slowed markedly; the current account deficit was persistently large and was financed increasingly by short-term inflows; and external debt was rising quickly. These problems, in turn, exposed other weaknesses in the economy, including substantial, unhedged foreign borrowing by the private sector, an inflated property market, and a weak and over-exposed banking system.

Markets pointed to the unsustainability of Thailand's policies: equity prices declined, and the exchange rate came under increasing pressure. The IMF stressed these problems and pressed for urgent action in a continuous dialogue with the Thai authorities during the 18 months leading up to the floating of the baht last July. But after so many years of outstanding macroeconomic performance, it was difficult for the authorities in Thailand--as in other countries--to recognize that severe underlying problems could seriously jeopardize their track record. And this "denial syndrome" contributed to the delay in taking corrective measures. Finally, in the absence of convincing action, the crisis broke.

We all have been troubled by developments in the Thai economy, both because they have been so costly for Thailand and its neighbors and because they were so preventable. But at least the origins of Thailand's problems are, by and large, clear. The more vexing question is why the crisis spread to other countries, such as Indonesia, Malaysia, the Philippines, and Korea.

Part of the explanation has to do with the fact that developments in the Thai economy undermined conditions in neighboring countries. For example, the depreciation of the baht was expected to erode the competitiveness of Thailand's trading partners, and that, in turn, put pressure on their currencies.

But beyond that, developments in Thailand prompted market participants--especially those who had initially underestimated the problems in Thailand--to take a much closer look at the risks in other countries. And what they saw--to different degrees in different economies--were many of the same problems affecting the Thai economy, including overvalued real estate markets, weak and over-extended banking sectors, poor prudential supervision, and substantial private short-term borrowing in foreign currency. Moreover, after Thailand, markets began to look more critically at weaknesses they had previously considered minor, or at least manageable, given time. In other words, markets became less forgiving.

Market doubts were compounded by a general lack of transparency--about the extent of government and central bank liabilities; about the underlying health of the financial sectors and about the links between banks, industry, and government and their possible impact on economic policy. In the absence of adequate information, markets tended to fear the worst and to doubt the capacity of governments to take timely corrective action. The imposition of controls on market activity--and the threat of future controls--not only made investments riskier, but tended to reinforce the view that governments were addressing the symptoms, rather than the causes, of their

problems. This sent investors fleeing to safer havens and set back other efforts to restore confidence.

But perhaps the most important factor in the depreciation of exchange rates was the rush by domestic corporations to buy foreign exchange. Expecting that exchange rates would remain stable indefinitely, and in the context of inefficient banking systems, domestic firms had borrowed heavily in foreign currencies in order to take advantage of lower interest rates available in other markets. Once they recognized that the peg might not hold and that their debt service costs might rise, perhaps dramatically, they hastened to sell domestic currency, extending the currency slide.

Finally, in some cases, the contagion can be traced in part to the "denial syndrome" that I referred to earlier--to the conviction that "it couldn't happen to us."

Questions have also arisen about the role of hedge funds. At the request of the NAB countries, the IMF has been looking into this question, talking to market participants and central banks about how hedge funds are set up and regulated, and what role they may have played in the crisis. But from what we know so far, it would be a mistake to blame hedge funds or other market participants for the turmoil in Asia. Turbulence in the market is only a symptom of more serious underlying problems, which are now being addressed seriously in many countries. Nevertheless, there are things that can be done to promote a more orderly working of the markets. For instance, consideration could be given to strengthening large trader reporting requirements; limiting position taking by requiring bankers and brokers to raise collateral and margin requirements so as to limit the use of leverage by hedge funds and other large investors; and other efforts to discourage herd behavior and avoid one-way bets, such as providing better information to markets on government policies and the condition of domestic financial institutions, to encourage investors to trade on fundamentals rather than to run with the herd.

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So what does all of this imply about the way in which governments should manage their economies and approach the markets?

The first implication is the most obvious one: the necessity of taking early action to correct macroeconomic imbalances before they precipitate a crisis. This did not happen in Thailand, despite timely and vigorous warnings. Instead, policymakers attacked the symptom of the crisis--the pressure on the baht--and accumulated large reserve losses and forward foreign exchange liabilities in the process. This, together with delays in addressing Thailand's severe financial sector problems and lingering political uncertainties, clearly contributed to a deepening of the crisis and its spread to other economies in the region.

Second, countries may find that they are more vulnerable to crises in other markets than their own economic fundamentals would suggest. Consequently, they may need to take preemptive action to strengthen their policies. Several suggestions come to mind as to where such action might be needed:

- one, maintaining an appropriate exchange rate and exchange rate regime. Clearly, there is no single "right" choice, but more flexible exchange rates can help provide early and visible signals of the need for policy adjustments and are less likely to invite reckless behavior on the part of borrowers and lenders. But regardless of the exchange rate arrangement chosen, appropriate macroeconomic policies are essential to ensure its success;
- two, maintaining an appropriate macroeconomic policy mix to ensure that fiscal positions do not lead to unduly high domestic interest rates, which, in many cases, have contributed to excessive amounts of short-term capital inflows;
- three, strengthening structural policies--especially the policies and institutions, such as prudential supervision, needed to underpin a sound financial system. In particular, it is important that fragilities in the financial system are not allowed to become so acute that the authorities are unwilling to use the interest rate instrument in times of international financial instability;
- and four, carrying out other supporting reforms--what we call "second generation" reforms--to promote domestic competition, increase transparency and accountability, improve governance, help ensure that the benefits of future growth are widely shared, and otherwise strengthen the foundations for future growth.

Developments have shown that whether a country follows prudent policies is not simply a matter of national concern. As we have seen in this region, spillover and contagion effects can be so rapid and so costly to countries with basically sound policies that every country has a strong interest in seeing that its neighbors manage their economies well. Experience shows that there is considerable scope for improving policies when neighboring countries get together on a regular basis to encourage one another--and, at times, to exert some peer pressure on one another--to pursue sound policies. For this reason, it is very encouraging to see the efforts under way to develop a mechanism for more intensive surveillance and dialogue among participating finance ministries and central banks of the Pacific rim to complement the IMF's global surveillance over its members' policies and performance. Of course, to be effective, regional surveillance has to be based on sound economic analysis. In this connection, the IMF stands ready to contribute to regional surveillance in Asia, as requested in the recent Manila meeting and Vancouver Summit meetings, and as it already does in the G-7 and other fora.

Developments in southeast Asia also offer some insight into how governments should approach markets. Perhaps the best place to start would be by giving credit where credit is due: the capital provided by global markets has been a key factor in southeast Asia's exceptional growth rates and its ability to lift so many out of poverty. Certainly, there are risks in tapping global markets. But markets also provide tremendous opportunities to accelerate growth and development, as southeast Asia itself so vividly shows. The key is to approach markets in a responsible manner--with strong macroeconomic fundamentals and sound structural policies that give markets confidence and therefore encourage long-term investment; with respect for the signals that markets provide; and with transparent and market-friendly policies that allow markets to allocate resources efficiently.

Let me say a few more words about the benefits of openness and transparency. When economic policies are transparent, policymakers have more incentive to pursue sound policies. If I may cite one pointed example among many, would the Central Bank of Thailand have accumulated such large forward liabilities if the public had had regular access to information on central bank operations? On the contrary, the authorities would have had to face the problem of Thailand's dwindling reserves much sooner; and most likely, they would have taken corrective action before reserve losses became so large.

Likewise, when timely, accurate, and comprehensive data are readily available, markets adjust more smoothly. Thus, countries are less vulnerable to adverse market reactions when problems eventually come to light, as indeed they always do. Especially when governments are trying to rebuild confidence, a free flow of information allows markets to assess the extent of underlying problems and the seriousness of efforts to correct them. Of course, transparency also limits the opportunities for corruption, which can otherwise distort resource allocation, undermine investor confidence, and inhibit growth. For all of these reasons, openness and transparency can make a substantial contribution to better policies, more stable markets, and hence, more sustainable growth.

Ultimately, the crisis in Asia underlines the need of an orderly liberalization of capital flows to ensure that a greater number of countries can benefit from access to international capital markets, while reducing risks. This does not mean a return to antiquated methods of capital controls, nor does it mean a mad rush to immediate, full liberalization regardless of the risks. Thus, we are working toward an amendment of our Articles of Agreement to include the liberalization of capital flows as a mandate of the IMF and to broaden the institution's jurisdiction to include capital movements, so as to ensure orderly liberalization and proper sequencing and that other requirements to reduce the risks and maximize the benefits of tapping global markets are in place.

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As developments have shown, confidence, once lost, is hard to regain. Restoring confidence takes a strong commitment to economic adjustment and reform demonstrated by the implementation of what are often painful measures. It also takes openness and transparency. And, of course, it takes time.

That process is now under way in southeast Asia. The first step has been to design effective strategies to reinforce macroeconomic policies, as needed, strengthen financial systems, and lay the basis for robust growth to resume. With the support of the IMF, Japan, and others in the region, Thailand's new government has recommitted itself to a courageous and comprehensive program that addresses the problems of large external deficits and troubled financial institutions. As a result, the budget is moving back into surplus and a comprehensive restructuring of the financial sector is getting under way. The Philippines has extended its program with the IMF under which a substantial amount of economic adjustment and reform had already taken place. Indonesia has embarked on a major Fund-supported program to strengthen monetary and fiscal policies, restructure the financial sector, and

deregulate the economy. South Korea is now working closely with the IMF to design a similar program that we expect will be worthy of broad international support.

Now comes the more difficult task: implementation. This is the task of the national authorities, and it takes leadership. One aspect of this leadership is to take responsibility for the programs being implemented, explain to citizens why adjustment is needed, and enlist their support. Too often citizens have the impression that the programs their governments are attempting to carry out have been imposed from outside. To authorities who have to carry out painful measures, this may seem convenient; but it is counterproductive because it undermines public support for their efforts. The IMF works very closely with the country authorities to design effective programs. We give our views on the pros and cons of various adjustment measures and on which combinations of measures are likely to work. Needless to say, we do not support programs we think will be ineffective. But ultimately, it is the authorities' decision what the program consists of. Our requirements are: one, that the program be well designed; and two, that it have the authorities' full support.

That being said, the IMF is there to help the countries of this region pull through this difficult period. The staff and management of the IMF are in constant dialogue with the authorities in the region. The programs we are supporting with our financial resources are bold, but realistic, and go to the heart of these economies' problems. In the case of Thailand, Indonesia, and soon Korea, IMF support has helped mobilize additional resources from other bilateral and multilateral resources. Along with the World Bank, the Asian Development Bank, and others, we are also providing a considerable amount of technical assistance, especially on financial sector issues.

Looking ahead, growth can be expected to rebound strongly after a relatively short, but sharp, weakening of economic activity, and a rapid narrowing of external deficits. In fact, we are already seeing improvements in exports, even though recent exchange rate changes have not had much opportunity yet to generate their effects. And as these adjustments take place, each of these countries will be embarking on a longer-term process of structural change that will strengthen their economies in fundamental ways--such as by restructuring their financial systems, increasing domestic competition, and otherwise improving the climate for productive investment and high, but sustainable, growth. That is why I believe that these economies will emerge from this period stronger and more dynamic than before.

What can you, as the business leaders of your countries, do to advance this process? The region has entered a period of slower growth, but with forceful action to tighten macroeconomic policies and forge ahead with financial sector restructuring and other structural measures, confidence can be restored sooner rather than later. One important way in which you can help shorten the period until stronger growth resumes is by helping to improve transparency--for example, by complying with "best practices" in accounting standards in the corporate sector, and by avoiding "connected lending" and other practices that raise doubts about the strength of corporate governance and the links between government, banks and industry. Such

steps will help convince markets that your countries do indeed embrace reform and that they have the resolve to put current problems behind them.

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